A MOMENT IN MARKETS – COMMODITY RETURNS CAN BE ENHANCED

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In A moment in markets – Are we in a commodity supercycle? the promising environment for commodities, especially sectors like industrial metals, was outlined. But for investors who endorse the case for commodities, portfolio implementation is the natural next step to ponder over. In many cases, having a pure beta exposure to commodities makes perfect sense. In some instances, however, smarter approaches present viable alternatives.

The return breakdown

Investors who are not interested in storing physical commodities are likely to seek synthetic exposures to the asset class. Exchange-traded commodity products are either physically-backed or synthetic, i.e., exposed to futures. When it comes to commodity futures exposure, the total return to investors is as follows:

Total Return = Spot Return + Carry Return + Collateral Return

(Return associated with spot price of commodity)
(Return from maintaining futures exposure by rolling positions from one
(Return from collateral used to guarantee futures position)

To avoid getting physical delivery of commodities upon expiry of the futures contract, investors maintain their exposure by rolling their futures position to a contract with later maturity.

This process can incur a carry return because futures prices may converge to spot prices over time, i.e., there is a gain or loss in carrying the futures contract up or down the curve. When futures curves are in contango, i.e., prices are upward sloping, roll yield is typically negative and when curves are in backwardation, i.e., prices are downwards sloping, roll yield is typically positive.

A pure beta approach would normally provide exposure to contracts towards the front end of the futures curve. Such strategies tend to do well relative to those that are exposed to contracts further out along the futures curve when commodity prices are in a bull run and the spot return component is dominating total returns.

This is because contracts at the front end are closer to the spot price and normally

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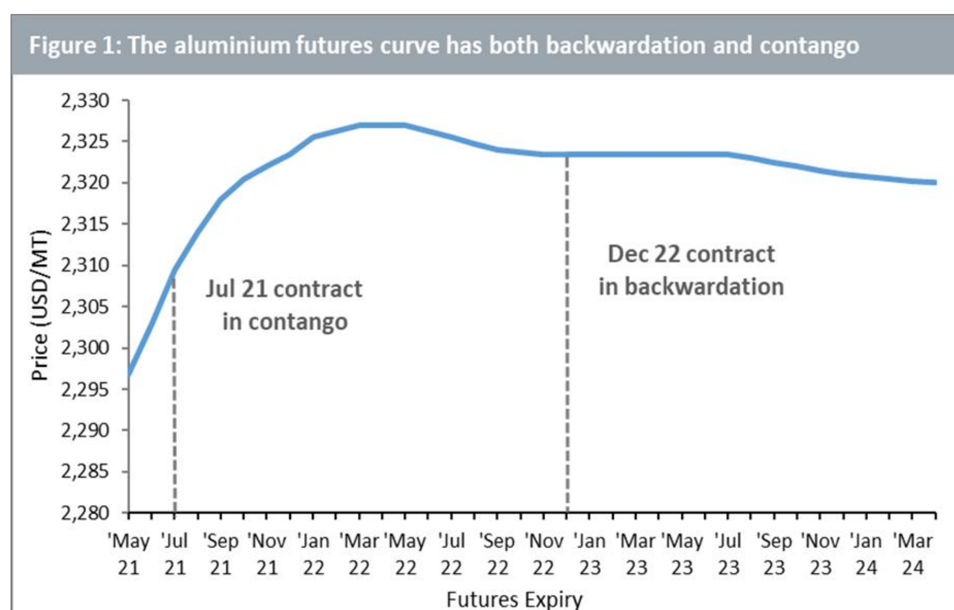
experience higher price fluctuation than those further along the curve. The roll return will, however, depend on the shape of the futures curve.

Optimizing the roll return

In contrast to the front-month approach, a dynamic approach to selecting futures contracts that promises a potentially better roll yield can add incremental value to total returns over a longer period. For example, the Bloomberg Commodity Index (BCOM) approach invests in contracts towards the front end of the futures contract[1].

In figure 1 the case of aluminium is currently the July 2021 contract. In contrast, the S&P GSCI Aluminium Dynamic Roll Index, which reassesses its exposure monthly and can go further out on the curve, is currently in the December 2022 contract.

Looking at the shape of aluminium's futures curve, we can observe that while July 2021 faces contango, the curve is in slight backwardation around the December 2022 contract (see figure 1 below).



Source: Bloomberg, Data as of 20 April 2021.

Certain approaches give exposure to specific points along the futures curve, e.g., the UBS Bloomberg Constant Maturity Commodity Index (CMCI). Each approach has its own merits and investors should take the time to familiarise themselves with the methodology.

The key distinction for a dynamic approach in the current macro environment is that sharp fluctuations in demand and supply conditions in recent months have caused futures curves to frequently change shape. Aluminium's entire curve at the end of January was in steep contango before becoming much flatter when supply curtailment from Inner Mongolia in March tightened the market.

While there is no single formula to predict which approach will outperform when, it is useful to recognise that curves can change shape, and this can have an impact on roll returns.

Figure 2: Smart strategies have historically added value over long time periods

Sources: WisdomTree, Bloomberg. Data from 31/05/01 to 31/03/21 and based on monthly returns. The Optimised Roll Commodity Total Return Index started its live calculation on 30/07/13. Calculations are based on total return indices and include backtested data.

Historical performance is not an indication of future performance and any investments may go down in value.

The deciding factor

With all the options available to investors, the decision comes down to whether the commodity exposure is a strategic or tactical decision. Enhanced approaches aim to add value by improving the carry return and reducing volatility – as longer tenor contracts tend to exhibit less price fluctuation compared to front-month contracts.

The true benefit of smarter approaches that seek to enhance the risk-return profile of commodities becomes apparent over longer periods (see figure 2). Enhanced approaches are, therefore, better suited to strategic investors looking for broad commodities exposure.

Sources

[1] Bloomberg Commodity Index

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